APPENDIX A
DONOR-ADVISED FUND REFORMS

At present, neither the Internal Revenue Code nor the Treasury Regulations define a donor-advised fund ("DAF"), although this is one of the fastest-growing forms of charitable giving. For purposes of this discussion and for the convenience of the reader, we offer the following informal working definition of a DAF, as stated in the Section of Taxation's letter:

> A DAF is not a separate legal entity; rather, it is a bookkeeping entry on the books of a public charity, identifying assets as to which a donor may make non-binding precatory recommendations to the public charity for charitable distributions and for investment (the "donor advice" of the name). The assets of a DAF belong to the public charity which has control over those assets and discretion as to their investment and use.

The lack of donor control is a key element of the DAF concept. Whether the public charity that owns the DAF assets is a community foundation, a university, a religious institution, a commercially-sponsored charitable gift fund, or an internationally-focused public charity, the public charity is governed by an independent board of directors that has ultimate authority and responsibility over all distributions, including those from assets subject to donor advice.

The Discussion Draft makes eleven specific proposals regarding the regulation of DAFs (in addition to a proposed ban on the ability of private foundations to make grants to public charities for DAFs, which we address in the Tax Section's letter). We endorse several of these proposals as being consistent with the practices of many responsible public charities that operate DAF programs. In particular, we support the following proposals:

- A public charity would not be permitted to make grants from DAFs to non-operating private foundations.
- A public charity would be required to secure from the grantee an acknowledgment that a grant from a DAF will not convey a private benefit to the advising donor.
- A public charity that holds assets in DAFs would be required to disclose the existence of the DAFs on its Form 990.
- A public charity would be able to accept donor advice to satisfy a donor's non-binding charitable pledge.[1]
- A public charity would hire investment managers for its DAF assets according to arm's length principles.
- Fees for referrals or transfers of funds to a DAF would be limited.
- Public charities with DAFs would have to impose a minimum activity threshold on each DAF.[2]

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[1] We believe that the tax consequences of allowing a public charity to implement donor advice to pay a donor's legally binding charitable pledge require further study. A non-binding pledge, however, does not raise those issues.
[2] The definition of required minimum activity, including the period of time over which it is measured, poses numerous technical questions. We endorse this proposal in concept, pending the development of answers to those questions.

We turn now to five proposals as to which we have more detailed comments.

Proposal 1 would require public charities to dispose of contributions to a DAF, other than cash or publicly traded securities, within one year of contribution and would require them to have a plan for sale at the time of the gift. Alternatively, a DAF could accept only cash or publicly traded securities. We assume that this proposal was prompted by concerns regarding the valuation of property for which the donor must obtain a qualified appraisal.[3] We further assume that the requirement of sale within one year is intended to allow the IRS to identify any significant differences in the amount of the charitable deduction claimed by the donor and the sales price on disposition by the charity, by means of the charity's reporting on IRS Form 8282. The issue of proper valuation of "qualified appraisal" property is not limited to gifts to DAFs and should be considered in the larger context of valuation of charitable gifts generally. For example, an unrestricted donation to the local children's hospital of pre-IPO stock that, under the Securities and Exchange Commission's rules, may not be sold for a specified period, raises the same valuation issues as a donation of the same stock to a community foundation DAF (or, indeed, to a commercially-sponsored national gift fund DAF). In the interests of consistency in the tax law, we recommend analyzing the valuation of "qualified appraisal" property in the broader context of donations generally, rather than viewing it solely in the context of DAFs. We do not support Proposal 1 in its current form.

Proposal 2 contains two elements: a prohibition on a public charity's grants from DAFs to private non-operating foundations, which we support, and a prohibition on a public charity's grants from DAFs to individuals, which we suggest is overly broad. We assume that the former prohibition is designed to prevent donors from claiming the more generous tax benefits available under law for donations to public charities and then recommending a grant to a private foundation controlled by the donor (or by family members or related business entities). We understand that most reputable public charities with DAFs have already adopted policies banning such transactions. With regard to grants from DAFs to individuals, however, we suggest that the public charity's discretion and control – particularly in the context of community foundation DAFs – provide an important safeguard against abuse. Anecdotal evidence suggests that those community foundations that make grants to individuals from their DAFs typically restrict the practice to scholarships, and while the donor is often involved in the selection process, e.g. by participating on the selection committee, the donor does not control the selection.

We note that the IRS has recently begun a market segment study of community foundations. DAFs will form a significant element of that study because of the significant amount of community foundation assets in the form of DAFs. We suggest that the results of the market segment study will provide a factual baseline that will assist the Senate Finance Committee as well as the IRS to assess whether restrictions are needed on grants from public charity DAFs to individuals. Pending that study, we suggest that additional enforcement of existing prohibitions against private benefit and inurement is the best approach. If the Committee believes that legislation is necessary, however, we suggest that since the issue is

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[3] *See* Treas. Reg. § 1.170A-13(c)(3).

improper donor control, the most appropriate remedy is to strengthen the public charity's control of the DAF assets by requiring any grants from DAFs to individuals to be approved by a selection committee, appointed by the public charity, on which the donor may serve but which the donor does not control.

Proposal 4 states: "A DAF would be required to meet an aggregate annual payout consisting solely of grants paid of 5% of the DAF's assets. Failure to meet the payout would result in a tax similar to that applicable to private non-operating foundations." A DAF, as noted above, is not a separate organization or entity but merely a bookkeeping entry that describes certain assets of a public charity. The reference to an "aggregate annual payout" leads us to believe that the drafters intended to refer to the public charity that owns the DAF assets and not to each individual DAF that a public charity might own. Our comments address that interpretation.

We believe that the payout proposal should be reconsidered. We note that grantmaking public charities, particularly community foundations, often have adopted spending policies under which they aim at distributing a percentage of assets that allows them to build reserves, while still serving the community with grants. These reserves are then available to meet community needs during difficult times, because a board may vary the spending policy in response to such needs. The Uniform Management of Institutional Funds Act, known as UMIFA,[4] and other state laws may impose certain requirements on DAFs that are classified as endowments, such as a prohibition against making expenditures that would cause the DAF value to fall below the historic dollar value of gifts to the DAF. Finally, a number of community foundations may hold the reserve funds of other public charities in the community in a DAF where the local charity itself is the donor-advisor, so that the smaller charity may benefit from the investment expertise available to charities with larger aggregate assets. These reserve funds, sometimes called agency endowments (though not always true endowments from a legal or accounting perspective), may see no activity other than the receipt of investment income until the local charity needs funds. These examples illustrate the complexity of the situation.

If the payout proposal is prompted by concerns that donors are "parking" funds in DAFs with no ultimate benefit to the community, we suggest that a minimum activity requirement, which looks at a period of years rather than focusing on one year at a time, may address perceived issues. We also suggest that the situation of community foundation DAFs is distinctive, since in order to qualify as a community foundation in the first place the charity must have the power (known as the "variance power") to use its assets for community needs in its complete discretion.[5] In any case, we suggest that the payout proposal would benefit from further study and from discussions with community foundations and other responsible public charities with DAFs.

Turning to international philanthropy, we have serious concerns about the unintended consequences that would flow from Proposal 7, which would bar a public charity from making grants from a DAF to any foreign organization that did not appear on an IRS

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[4] Unif. Mgmt. of Inst. Funds Act (1972) (adopted in all states except, Alaska, Arizona, Florida, Pennsylvania and South Dakota).
[5] *See* Treas. Reg. § 1.170A-9(e)(11)(v)(B)(1).

published list of approved foreign organizations.[6] We emphasize, again, that DAF assets belong to public charities which have discretion and control as to their use. We see no reason to distinguish between public charity grants from general funds and public charity grants from funds as to which donors have the right to make non-binding recommendations. Responsible public charities that make grants to foreign organizations, whether from general fund assets or from DAFs, commonly exercise a high level of due diligence before the grant is made and require reports on how the funds were used.[7] Since September 2001, international grantmakers – whether public charities or private foundations – have invested significant resources in developing procedures and practices to prevent the diversion of charitable assets to violent or terrorist ends. Individual donors, private foundations, and public charities without international expertise have made advised gifts to public charities with international due diligence capability in order to support good works abroad in a legally compliant manner. We believe that this practice should be encouraged rather than discouraged. Finally, if Proposal 7 was prompted by concerns about international grantmaking generally, we suggest that this topic should be considered separately and not as part of an effort to regulate the donor-advised sector.

Finally, we are not sure what prompted Proposal 10: "A DAF generally would not be permitted to expend amounts for grantee selection, such as site visits, that extend beyond basic due diligence of grant approval." A public charity that owns DAF assets generally conducts such due diligence as may be appropriate in the circumstances. Where the donor recommends grants for specific projects, the public charity may reasonably conclude that more due diligence is required and may, thus, expend more resources from the DAF on staff oversight. If the drafters are concerned that public charities may be reimbursing excessive or improper expenses of donors who volunteer their time for distant site visits, for example, this may be corrected with more targeted reforms, such as limits on the reimbursement of donors' expenses (and the expenses of their family members or related entities) in connection with selection activities.

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[6] Currently there is no such list. It is not clear to us how the IRS, whose resources are stretched thin with overseeing more than 1.6 million domestic charities and EOs, could develop standards for accrediting charities organized under the laws of other countries.

[7] *See* "Comments in Response to Internal Revenue Service Announcement 2003-29, 2003-20 I.R.B. 928, Regarding International Grant-Making and International Activities by Domestic Section 501(c)(3) Organizations," submitted to the Internal Revenue Service by individual members of the Committee on Exempt Organizations of the Section of Taxation on July 18, 2003, and available at http://www.abanet.org/tax/pubpolicy/2003/030714exo.pdf.